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85-218

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1984

LUXURY BLANKETS, INC.; BENJAMIN RUPERT; ELAINE RUPERT,

PETITIONERS

v.

UNITED STATES OF AMERICA,

RESPONDENT

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether the Court of Appeals erred in holding an illegal contract enforceable against an innocent businessman where the formation of the contract was obtained by the affirmative misconduct of the Small Business Administration in conjunction with a local banker?

2. Whether the Court of Appeals erred in holding that the actions of the Small Business Administration did not constitute an abuse of discretion in violation of 5 U.S.C. §706 (2)(a) of the Administrative Procedure Act?

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IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1984

LUXURY BLANKETS, INC.; BENJAMIN RUPERT;
ELAINE RUPERT,

PETITIONERS

V.

UNITED STATES OF AMERICA,

RESPONDENT

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The petitioners Benjamin Rupert and Elaine Rupert and Luxury Blankets, Inc. respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for

the Sixth Circuit entered in this proceeding on April 23, 1985.

OPINION BELOW

The unpublished opinion of the Court of Appeals in the Appendix A hereto. An opinion was issued January 19, 1984 by the United States District Court for the Northern District of Ohio, Western Division. The opinion of the District Court appears in the Appendix B hereto.

JURISDICTION

The judgment of the Court of Appeals for the Sixth Circuit was entered April 23, 1985. This petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254 (1).

STATUTORY PROVISIONS INVOLVED

5 U.S.C. § 706

15 U.S.C. § 696, § 661, 13 C.F.R. § 108.

502-1

STATEMENT OF THE CASE

A. NATURE OF THE CASE, THE COURSE OF PROCEEDINGS, AND ITS DISPOSITION IN THE COURTS BELOW.

On November 2, 1976, the United States of America, on behalf of its agency, the Small Business Administration, filed its Amended Complaint against Luxury Blankets, Inc. of ST. Mary's, Ohio and Benjamin Rupert, Elaine Rupert and Marvelle Rupert for judgment on a note and foreclosure of a mortgage dated November 17, 1969. The Small Business Administration was an assignee - purchaser of this note and mortgage on March 6, 1973 from the Home Banking Company (of St. Mary's, Ohio) who was an assignee purchaser of the note and mortgage from the Community Improvement Corporation of St. Mary's, Ohio.

An Answer was duly filed and a Third Party Complaint was filed by Luxury

Blankets, Inc. and the Rupert family on March 23, 1978 against the Small Business Administration for damages due to wrongful acts of the government through its employees - agents.

Discovery was undertaken and numerous motions were filed.

On January 14 and 15, 1980 the case was heard in trial by District Judge Don J. Young without a jury, and on January 19, 1984 Judge Young decided the case and issued an Opinion And Order, based on which a judgment was filed on June 5, 1984, in the District Court.

On June 29, 1984, the Notice of Appeal was filed, IN THE UNITED STATES COURT OF APPEALS SIXTH CIRCUIT. Briefs were filed, the Appendix was filed, and oral argument was had on March 28, 1985. On April 23, 1985 the Court of Appeals filed the order affirming the district

court's judgment. This order was issued as a Mandate on May 16, 1985.

B. STATEMENT OF THE FACTS RELEVANT TO THE ISSUES PRESENTED

The facts are not much in dispute and the District Court's Opinion and Order filed January 19, 1984, particularly pages 3 through 11 consists of a discussion of the facts and many findings of fact. The facts are also in the trial transcript and the exhibits.

Luxury Blankets, Inc. is an Ohio corporation in the blanket manufacturing business in St. Marys, a small town in the western part of Ohio, about halfway between Cincinnati and Toledo, near Lima, Ohio.

The case involves fraud and collusion by a U.S. Government employee in a Small Business Administration (SBA) loan which was a quid pro quo with the

Home Banking Company (HBC) of St. Marys for the bank's personal mortgage loan to the SBA employee, Albert Mazza.

The plot of fraud and collusion between Albert Mazza, the SBA employee, and the bank (HBC) president, Norman Kuhlman, is twisted and must be unraveled. In order to unravel the plot it is necessary to refer to the following persons:

BEN RUPERT - President of Luxury Blankets, Inc. An old customer of the only bank in town who owed money to the bank and was current on repayment.

NORMAN KUHLMAN - President of the only bank in town and president of CIC and Director of Celina Insurance Co. He concocted the paper charade with Albert

Mazza to "bail-out" the bank from the old Luxury Blanket, Inc. loan.

ALBERT MAZZA - SBA loan officer who needed a personal loan from the bank to buy his family a home as he had bad credit. He concocted the paper charade with Kuhlman and got his home loan from Kuhlman's bank and Kuhlman's insurance company.

Luxury Blankets, Inc. is basically a Rupert family corporation which has been manufacturing blankets in St. Marys, Ohio since 1946. It was located on Nagle Street from 1946 through 1968 and in order to expand, purchased the Greenville Road building in May, 1967, and additional machinery in 1966 and early 1967 and im-

provements to the building in early 1968.

Luxury and the Ruperts had done most of their banking business with the only bank in town, Home Banking Company (HBC) since 1946 and had borrowed and paid back loans over the years, and had borrowed money for the blanket business expansion from the bank. Norman Kuhlman became president of the bank (HBC) in 1964. The exact amount owed by Luxury and Ruperts to the bank (HBC) before the SBA involvement was never clearly established because the bank president "didn't know" at trial but the amount was either "approaching the bank's loaning range" according to the bank president Kuhlman and had "exceeded his loan limitation."

The bank president Kuhlman decided that since he had exceeded his loaning limit he wanted to reduce the bank's

risk on the loan. Ben Rupert suggested that HBC carry half the loan and that another nearby bank carry half the loan.

Instead, the bank president Kuhlman decided to contact the SBA in late 1968 or early 1969 to get his bank off the loan. It was this contact between Kuhlman and Albert Mazza of the SBA that started the chain of events that led to the conspiracy, fraud and illegality.

In October, 1968, Mazza had transferred on his SBA job from Pittsburg to Columbus, Ohio. Mazza had left Pittsburg with a court judgment against him and he had committed to buy a house in Columbus, Ohio, but he could not obtain a mortgage loan due to his bad credit. Mazza badly needed this mortgage loan and arranged as a quid pro quo with Kuhlman to get a mortgage loan "bail-out" for himself (Mazza)

in exchange for getting a "bail-out" SBA loan for the bank. This, of course, was not legal, and the transaction must be covered up, and in order to cover up the transaction Mazza and Kuhlman set out to create a "paper charade" and "paper sham" of which Ben Rupert was not aware.

The Section 502 SBA loan regulations were that the SBA could not loan the full amount of money for a business, and part of the capital had to be injected by "local development companies" (15 U.S.C.§ 696,C.F.R. §108.502-1) St. Marys, Ohio had a "local development company," namely the Community Improvement Corporation (CIC) which Kuhlman had organized in about 1965 and had been president of since about 1965. The CIC was a necessary tool for the paper charade and paper sham. The CIC did not have and never had any money to inject into

any business, but to create the paper charade and paper sham it needed to appear as if it did.

The CIC had funds of only about $500 but the SBA required the CIC inject $40,000. This was a problem for Kuhlman and Mazza. Mazza and Kuhlman solved the problem of the missing $40,000 by creating documents that appeared that the $40,000 was injected by the CIC and then forgiven (on November 12, 1969) by the CIC. The $40,000 necessary for the "bail-out" for the bank appeared and disappeared in an instant in the sham paperwork which was signed November 17, 1969.

The CIC - Kuhlman - assigned the documents to HBC on November 17, 1969.

Mazza got his $29,500 home mortgage loan. Mazza applied for (in September, 1969) and got his home mortgage loan

from Kuhlman's bank (Mazza's loan closed December 19, 1969) and Mazza's home loan was sold by HBC - Kuhlman's bank - to Celina Insurance Co. where Kuhlman was a director.

Immediately after Kuhlman was bailed out from the loans exceeding his limit the climate changed. Kuhlman had nothing to worry about at this point as he was, in effect, off the loans to Luxury and Ruperts as the SBA had guaranteed them. He could now do as he pleased with Luxury and Ruperts. As soon as Rupert signed the documents, Kuhlman grabbed them and said "Now, if you stay in business, what kind of a person are you going to be?" Kuhlman's bank took Luxury's and Rupert's blankets worth $120,000 which caused the company to "hardly operate". Kuhlman was a tenant of Luxury in the old Nagle Street

property of Luxury and he stopped paying rent and storage.

The documents had indicated a $260,000 loan from CIC to Luxury, co-signed by the Ruperts personally with $40,000 forgiven on the back side of the document. This appeared to be a net amount of $220,000 owed to CIC. There was a note and mortgage. Luxury and Rupert made no payments on the $220,000 "loan". The "loan" became immediately in default in early 1970; no payments because no rent and blankets taken.

In June, 1970, another SBA official, Mr. William Arnold, received and reviewed this and other 502 loan files. At this point the SBA had no money involved, only a guarantee to the bank (HBC). Mr. Arnold investigated and went to St. Marys, Ohio, on July 30, 1970, with Mr. McCarthy

of the SBA and they uncovered the paper charade and paper sham created by Mr. Kuhlman and Mr. Mazza. Mr. McCarthy and Mr. Arnold learned in July and August, 1970, that the $40,000 had not been injected and also that HBC had loaned to Mazza his $29,500 home mortgage loan and Arnold and McCarthy reported the "bail-out" to the SBA. Mazza resigned involuntarily from the SBA in 1970. Nothing happened. Luxury made no payments.

Glenn Weaver of the SBA was assigned to the loan in 1972. Glenn Weaver investigated for the SBA. He talked to the CIC. They "hemmed and hawed" about the $40,000 and Mr. Weaver was puzzled. He was then told by Mr. Thomas Cramer of the SBA, who had been with a "small bank in the western part of Ohio" himself, to "Keep your hands off" because Mr. Kuhlman, anoth-

er banker is a small town in western Ohio (St. Marys), had requested that Glenn Weaver be removed. Weaver was removed from the case, obviously because he had again dredged up the fraud which had been previously silenced.

At this point, SBA had been clearly made aware of the fraud and conspiracy and illegality, first in 1970 by Mr. Arnold and Mr. McCarthy, and again in 1972 by Mr. Weaver. Nothing happened. Luxury made no payments. This was about 2 years following the "loan".

On February 1, 1973, HBC wrote to the SBA to purchase the loan balance. A transmittal letter of February 20, 1973, from SBA to the bank with the $224,870.78 U.S. Treasury Check No. 93,584,749, dated February 13, 1973 states:

> "Please be advised by cashing this check Bank agrees that demand and delivery of check does not constitute a waiver of any of SBA's rights against Bank. These rights include, without limitation, the right to recover damages for any failure of Bank to make or service the loan according to the Authorization, for any breach by Bank of the Guaranty Agreement, or for any fraud or misrepresentation."
>
> This is language of recourse.

On March 6, 1973, the HBC assigned the notes and mortgage to the SBA using the words "without recourse".

Luxury and Ruperts knew nothing of this assignment, and they made no payments. On April 8, 1974, the SBA wrote demand letters to Ruperts and Luxury.

Luxury and Ruperts did not pay. The SBA filed its Complaint in District Court and later its Amended Complaint.

In its Findings of Fact portion of the Opinion the Court found at Page 6:

Opinion, page 6 - "Although the evidence is not entirely clear on just who concocted the so-called $40,000 forgiveness by CIC scheme, there is no real doubt but that it was the product of Albert Mazza's imagination. He and Mr. Kuhlman were well aware that unless a paper charade was designed to somehow account for the required capital donation by the CIC, the loan might not receive SBA sanction. Consequently, the SBA probably would not have guaranteed the loan, the HBC would hav[illegible] grossly (p.7) exceeded its lending limit to Luxury and Mr. Kuhlman would have been in serious trouble.

There is no dispute about the fact that Luxury did not owe the CIC $40,000. There is also no doubt that the CIC virtually was penniless. It is also clear that the parties simply were attempting to juggle figures so as to insure SBA's guarantee of the loan. Hence, the paper sham, of the details of which Mr. Rupert was not aware when signing the stack of documents on November 17, 1969.

The evidence further shows that, according to the SBA's loan author-

> ization, the loan should not have been disbursed absent of the CIC's required injection. It nevertheless was. It is no mere coincidence that the loan closing date closely parallels Mr. Mazza's home loan from the HBC. The two transactions are part and parcel of the same scheme to secure the SBA's guarantee on a loan that otherwise might not have been guaranteed, and represent quid pro quos between Mazza and Kuhlman.

The Sixth Circuit Court of Appeals held: "Appellants are correct that the contract is illegal."

The Sixth Circuit Court of Appeals held: "Consequently, the district court erred in finding that appellants failed to establish their affirmative defense of illegality." Despite that error, the illegal loan contract must be enforced."

REASONS FOR GRANTING THE WRIT

1. THE DECISION BELOW ESTABLISHES A PRECEDENT WHICH TACITLY PERMITS GOVERNMENTAL AGENTS TO PARTICIPATE IN ILLEGAL CONTRACTS

AND CREATES THE POTENTIAL FOR SOCIETIAL DISTRUST OF AN IMPORTANT FEDERAL ADMINISTRATIVE AGENCY.

The underlying purpose of the establishment of the Small Business Administration and its attendant Congressional directives such as the Small Business Investment Act, see, 15 USCS§661, was to create an administrative agency designated the task to promulgate rules, and implement procedures which would guarantee confidence both in the business community and with the general populace. Congress understood the essentiality of providing,"...sound financing of...business operations and (the need for) their growth, and modernization ..."[1] and the importance of maintaining,

[1]See generally, 15 U.S.C.S.§661

if not stimulate, employment through the involvement of private entreprenial investment. Unfortunately, the Sixth Circuit decision below violates these mandates and unintentionally establishes a protective barrier to governmental misconduct which will destroy public confidence in the Small Business Administration.

After determining that the District Court erred in finding that, "appellants failed to establish their affirmative defense of illegality," the Sixth Circuit nevertheless concluded, that, " the illegal loan contract must be enforced." Relying upon an arguably non-analogous case California Pacific Bank v. Small Business Administration, 557 F.2d. 218 (9th Cir. 1977), they held that illegal contracts are unenforceable only if two elements are present. Citing the Restatement (Second)

of Contracts § 320 (1) at 53 (Tent. Draft No. 12, March 1, 1977), the Sixth Circuit urged that the second element ought be applied - where the interest in (the contract's) enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms. While the petitioner's fully concur that the aforementioned section of the restatement is appropriate, the application of the concept is not grounded upon accepted understanding of public policy or principles of equity.

The Sixth Circuit's one sentence analysis of the important considerations attached to a determination of public policy and fundamental fairness necessitates close scrutiny by our nation's highest court. The Sixth Circuit concluded, "...we believe that the economic policy of

ensuring the joint participation of the SBA and a development corporation does not clearly outweight the interest in contract enforcement when the public fisc, the parties' expectations, and unjust enrichment are at stake." The court's cursory analysis in this case can only be categorized as unacceptable. Not only did the petitioners not expect that their warehoused products would be collateral for a past debt, rendering them incapable of continuing their commercial activities, but more importantly, they believed that the acquistion of a loan from the bank guaranteed by the Small Business Administration would provide them with the necessary finances to expand their business and subsequently honor their creditors. Their "expectations" were that they had received a long-term assurance by our government

that a good faith agreement had been entered into between the parties. Instead the government, acting through its agent created a paper charade which in effect provided a "bail-out" to a local bank which had determined that it would use the public fisc to guarantee collection of past loans with the petitioners. For the Sixth Circuit to impliedly suggest that such collusive activity culminating in what the court found to be "illegal" conduct ought be weighed against the only good-faith participant's expectation is questionable at its best. It must be presumed, because of the dearth of explication that the Sixth Circuit provided in their opinion, that the court believed that finding for the petitioner would have a significant impact upon the public treasury. Such is not the case. The government can readily

secure the debt by bringing an action against the local bank which participated in the fraud. Indeed, counsel for the petitioner suggested such a remedy to the Sixth Circuit. But even assuming that such action was not instituted, the "public fisc" will be invaded to a much larger extent if the illegal practices which permitted this loan agreement are not forcefully rejected by the Supreme Court of the United States.

It is a well-accepted principle of contract law that, "contracts injuriously affecting public or government service are invalid."[2] Such contracts are believed to be contrary to public policy.

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[2] 17 American Jurisprudence Second, §210, p. 578.

The reason for this theory is, "to prevent persons from assuming a position where selfish motives may impel them to sacrifice the public good to private benefit."[3] That the Sixth Circuit overlooked the underlying special status that public officials must possess in their associations with private citizens is an oversight which must be corrected. Every theory of public policy dictates that administrative agents be put on notice by our courts of justice that their illegal behavior will not be tolerated. To suggest, as has the Sixth Circuit, that illegal conduct which involved one of the most important appendiges of public financing - the Small Business Administration - can be permitted, and that principles of public policy require

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[3]Id. at 579.

enforcement, is to render illusory the high standard of care which attaches to administrative officers. The impact of the Sixth Circuit decision , left without Supreme Court review, will be a continuing sense of distrust, not only in the operation of the Small Business Administration, but as applied to our entire federal administrative bureaucracy.

In a series of cases, the federal judiciary had applied principles of equity in an effort to establish the appropriate balance between the necessity of encouraging contractual freedom and minimizing governmental wrongdoing with private citizens. In most of these decisions the thrust of the courts analyzes have centered upon whether the government's conduct can be categorized as "affirmative misconduct."[4]

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[4]Immigration and Naturalization Service v. Hibi, 414 U.S. 5,8 (1973)

The Sixth Circuit's finding of illegality certainly falls within the purview of this standard. Not only did the agent for the Small Business Administration secure a personal loan from the local bank which sought SBA involvement, but also the transcript from the District Court is heavily leadened with facts attesting to numerous situations where the agency had full knowledge of the "bail-out" quality of the request and of irregularities in the design of the development corporation required by the loan agreement. Of particular importance for this case is the estoppel theory used by some federal courts in contract and administrative disputes.[5]

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[5]Interstate Fire Insurance Co. v. United States, 215 F. Supp. 586,600 (E. D. Tenn 1963), aff'd mem, 339 F. 2d. 603 (6th Cir. 1964); McQuagge v. United States, 197 F. Supp. 460, 469-71 (W.D. La. 1961); Kemp v. United States, 38 F. Supp 568,571 (D.Md 1941) For an excellent overview of equitable estoppel see, note, 79 Columbia Law Review 551 (1979).

In these cases, the courts have accepted the validity of contractual non-enforcement where estoppel can serve as a reprimand for "governmental bad faith or inexcusable impropriety."[6]

These principles of equity and public policy justify the grant of certiorari to review the judgment below:

2. THE DECISION BELOW ERRED IN NOT FINDING THAT THE ACTION OF THE SMALL BUSINESS ADMINISTRATION WAS AN ABUSE OF DISCRETION IN VIOLATION OF 5 U.S.C.§706 OF THE ADMINISTRATIVE PROCEDURE ACT.

In the alternative that principles of equity or estoppel are found to be inappropriate for judicial application on review, the petitioners contend that the

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[6]Id. Note, at 570.

Sixth Circuit's reluctance to address this allegation is reversible error and basis for review. 5 U.S.C. §706 of the Administrative Procedure act states in part, that courts may "... set aside agency action... found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law."[7] The action of both lower echelon and higher level Small Business Administration officials was exhaustively documented at both the trial and appellate stages of this case. Indeed, it was this obvious involvement by the agency officials and the local bank president which most assuredly led the Sixth Circuit to conclude that they had participated in the formation of an illegal contract.

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[7] See generally, K.C. Davis, Administrative Law of the Seventies §28.16 (1976).

The standard for judicial review of arbitrary, capricious, and abuse of discretion conduct by administrative officials in our federal bureaucracy had been articulated by both scholars of administrative law and by judges within the federal judiciary.[8] The generally accepted standard is that the reviewing court shall query whether a reasonably prudent administrator presented with the facts applicable to the case before the bar would have concluded as did the administrative officer whose conduct is in question. The court will determine whether in the plead-

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[8]Citizens to Preserve Overton Park v. Volpe, 401 U.S. 402,416 (1971); Sierra Club v. Costle, 657 F.2d 298,323, N. 67 (D.C. Cir. 1981); Motor Vehicle Manufacturers Assn. v. Ruckleshaus, 719 F.2dl159, 1164 (D.C. Cir 1983).

ings before him or her there is substantial evidence to support the administrative determination. While the activiation of §706 (2) (a) is the exception not the general rule by our federal judiciary, the considerations of administrative expertise which often provide the basis for a finding of no abuse of discretion in the majority of cases are not presented in this case.

Officials of the Small Business Administration clearly notified the Director, Office of Loan Administration of SBA of irregularities which the Sixth Circuit concluded provided the necessary elements for a finding of illegality. Placed in the position of public ward of loan monies for the citizens of this country, it would be only reasonable to expect that this administrative officer would heed the notices provided by subordinates as to the

loan application and refuse to authorize the loan. Not only did he authorize the activities of a lower echelon loan officer which he should have known were questionable practices at best, but even more important, was his seemingly cavalier attitude that the public fisc was not required to be protected by requiring indemnification from the local bank.

Without serious judicial review of administrative officers and their discretionary actions, the most important public policy consideration in our governmental system - check upon arbitrary action will be rendered useless and the need for citizen trust of their institutions will have been seriously crippled.

These considerations justify the grant of certiorari to review the judgment below.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Sixth Circuit.

Respectfully submitted,

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July 22, 1985

CERTIFICATE OF SERVICE

This is to Certify that I am a member of the Bar of the Supreme Court of the United States of America and that I have this date served three copies of the above and foregoing Petition For A Writ Of Certiorari upon each of the following persons by placing same in an envelope properly addressed to them with sufficient postage thereon for the same to arrive at their destinations and by placing same in the United States Mail addressed to them at the following addresses:

Verne K. Armstrong
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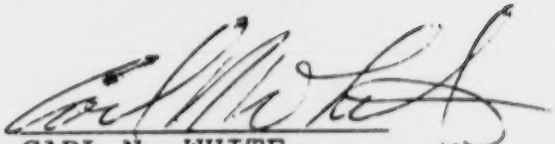
Mr. Charles Fried
Acting Solicitor General
Office of the Solicitor General
Department of Justice - Civil
Room 5143
Washington, D.C. 20530

This 22nd day of July, 1985.



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No. 84-3519

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

UNITED STATES OF AMERICA, Plaintiff-Appellee, v. LUXURY BLANKETS, INC.: BENJAMIN RUPERT; ELAINE RUPERT, Defendants-Appellants.	ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OHIO

BEFORE: KEITH and JONES, Circuit Judges; and DIGGS TAYLOR, District Judge.*

Per Curiam. Appellants, Luxury Blankets, Inc. (Luxury), Elaine Rupert, and Luxury's President, Benjamin Rupert, appeal from the judgment of the district court in a foreclosure action filed under 28 U.S.C. § 1345. This appeal presents issues regarding the affirmative defense of illegality and a statement concerning

*Honorable Anna Diggs Taylor, United States District Judge for the Eastern Districts of Michigan, sitting be designation.

conspiracy. We affirm.

When Luxury sought to expand its business, Benjamin Rupert asked Home Banking Company (HBC), which had financed much of Luxury's business, to make a loan of $260,000. It appears, however, that either HBC had reached or had exceeded its lending limit to Luxury. Consequently, HBC's president, Norman Kuhlman, approached Albert Mazza, a Small Business Administration representative, to secure the SBA's commitment to participate in a loan to Luxury pursuant to Section 502 of the Small Business Investment act, 15 U.S.C. § 696.

Afterwards, the SBA guaranteed a loan to Luxury from HBC and Community Improvement Corporation (CIC), a development corporation whose president was Kuhlman. The SBA's loan authorization

allowed the disbursement of a $220,000 loan to Luxury only after CIC gave Luxury $40,000 in the form of an equity capital injection.

CIC did not give Luxury the $40,000. Instead, Kuhlman executed a $220,000 promissory note on behalf of CIC in favor of HBC. Next, Benjamin and Elaine Rupert gave a $260,000 mortgage note secured by a mortgage deed; however, the reverse side of the note indicated that CIC forgave and considered liquidated $40,000 of the principal. Then, CIC assigned its interest in the mortgage note and deed to HBC. Subsequently, Benjamin, Elaine, and Mauralle Rupert unconditionally guaranteed payment of the assigned note and CIC filed financing statements regarding some of Luxury's machinery and equipment. Afterwards, the $220,000 loan

was disbursed.

Thus, it appears that Mazza and Kuhlman created a paper charade. The charade, details of which were unknown to Benjamin Rupert, was designed to account for the nonexistent but required $40,000 capital injection. The charade was also designed to ensure that Kuhlman would not violate bank policy be exceeding HBC's lending limit to Luxury; apparently HBC's limits did not apply to loans made after the SBA had given its guarantee. The charade was further designed to be a favor from Mazza to Kuhlman. In exchange for that favor, Kuhlman helped Mazza, against whom a Pittsburgh bank held an unsatisfied judgment, get an HBC loan; that loan's closing date closely parallels Luxury's loan.

The SBA investigated Luxury's loan and discovered that CIC failed to make its capital injection. An investigator noted that the charade was a "bail-out" for HBC's over exposure in loans to Luxury. SBA's district counsel ascertained that despite the charade CIC generally complied with the loan requirements. An SBA director concluded that HBC made the capital injection in fact, that Mazza and CIC did not create a conspiracy, and that CIC contributed enough to comply with 13 C.F.R. §108.502-1(e).

Thereafter, Luxury defaulted on its payments due under the loan. The SBA honored its guarantee and purchased the loan. During state court litigation HBC, Luxury, Benjamin Rupert, and others executed a general release.

The SBA sued Luxury and the

Ruperts to foreclose on the mortgage, to secure equipment, and to secure a judgment against the Ruperts based upon their unconditional guarantees. Luxury filed a third-party complaint against the SBA Administrator and sought a $260,000 judgment as damages for its noncompliance with federal regulations and for breach of duty. The district court entered judgment for the Government against Luxury and the Ruperts, jointly and severally, in a sum of $335,245.11 with interest.

On appeal this Court may freely review the district court's legal conclusions, ultimate findings of fact, and mixed questions of fact and law. Roth Steel Products v. Sharon Steel Corp., 705 F.2d 134 143 n.19 (6th Cir. 1983). We apply that standard to determine whether the district court erred in concluding that appellants

failed to establish their affirmative defense of illegality.

Illegal Contract

The district court was convinced that appellants failed to establish the affirmative defense of illegality. On appeal appellants contend that unrefuted evidence established Mazza's and Kuhlman's conspiracy and fraudulent conduct. Appellants' brief lists in detail the findings of fact, testimony, and exhibits used to support that contention.

The Government contends that the loan contract was legal. In support, the Government advances two reasons. First, neither paragraph four of the statute governing the SBA's 502 loan program nor 13 C.F.R. §108.502-1, the regulation used to implement the 502 loan program, requires the participation of a development company.

Second, the loan was not a "bail out" for HBC because the facts do not show that HBC was inadequately secured or in a position to sustain a loss.

We believe the Government is correct that neither the statute nor the regulations require a capital injection. Instead both the statute and the regulations make permissive a capital injection by a development corporation. The SBA's loan authorization in the instant case, however, makes mandatory CIC's $40,000 capital injection prior to disbursal of the $220,000.

Appellants are correct that the contract is illegal. According to the Restatement (Second) of Contracts, a contract is illegal "if either its formation or performance is criminal, tortious, or otherwise opposed to public policy."

Restatement (Second) of Contracts § 512. One economic policy underlying the statute governing SBA's loan program is that small business concerns accomplish their objectives either through the SBA loan or through the SBA loan in combination with a capital injection from a development corporation. Accord 13 C.F.R. § 108.502-1(e). Here that economic policy was frustrated in the formation of the loan contract since Mazza, Kuhlman, HBC, and CIC was not going to contribute the $40,000 required by SBA's loan authorization. The loan contract, therefore, fit the Restatement's definition of an illegal contract. Consequently, the district court erred in finding that appellants failed to establish their affirmative defense of illegality.

Despite that error, the illegal

loan contract must be enforced. As the district court noted the illegality of a contract does not automatically render its unenforceable. California Pacific Bank v. Small Business Administration, 557 F.2d 218 (9th Cir. 1977). Instead illegal contracts are unenforceable only "where (1) a statute explicitly provides that contracts contravening it are void or (2) where "the interest in [the contract's] enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms." Id. at 224 (quoting Restatement (Second) of Contracts §320(1) at 53 (Tent. Draft No. 12, March 1, 1977)). We, like the district court, have not discovered any statute or regulation indicating that CIC's failure to make the capital injection renders the underlying obligation void. Moreover,

we believe that the economic policy of ensuring the joint participation of the SBA and a development corporation does not clearly outweigh the interest in contract enforcement when the public fisc, the parties' expectations, and unjust enrichment are at stake. Additionally, the evidence clearly shows that appellants intended to and received $220,000 of financial assistance. It is clear that they intended to be responsible for it. To allow appellants to escape liability would result in their unjust reception of $220,000.

Conspiracy Statement

The district court said that an SBA director "concluded that there was no reason to believe that there was a conspiracy between the CIC and Mr. Mazza." Appellants contend that the district court

erred in holding that the SBA did not abuse its discretion in determining that there was "no reason to believe there was a conspiracy." Appellants' contention is erroneous because it characterizes the district court's language as a holding when, in fact, the language merely repeated the SBA director's conclusions. It is obvious that the repetition did not state or imply a legal principle.

We, therefore, AFFIRM the district court's judgment.

A TRUE COPY
Attest:
JOHN P. HEHMAN, Clerk
By_____
Deputy Clerk

ISSUED AS MANDATE: May 16, 1985
COSTS: None

IN THE SUPREME COURT
OF THE UNITED STATES

OCTOBER TERM, 1984

LUXURY BLANKETS, INC.;
BENJAMIN RUPERT;
ELAINE RUPERT,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

APPENDIX B
OPINION AND ORDER OF DISTRICT COURT

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IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
WESTERN DIVISION

UNITED STATES OF AMERICA,

Appellee

No. C 76-389

-versus-

LUXURY BLANKETS, INC.,

Appellant

FILED JANUARY 19, 1984

YOUNG J.

This is a civil action brought by the United States of America, on behalf of the Small Business Administration (SBA), an agency of the federal government. Jurisdiction of this action is predicated on 28 U.S.C. Sec. 1345.

Plantiff, in its amended complaint, seeks to foreclose on real property and business chattels held in the name of defendant Luxury Blankets, Inc. (Luxury), because of default on paments due under a loan, the payment of which was guaranteed by the SBA. Plantiff also seeks judgments against defendants Benjamin Rupert, Elaine Rupert, and Marvalle Rupert based on the unconditional guarantees executed by them to insure payment of the loan to defendant Luxury. All of the aforementioned defendants answered plaintiff's amended complaint and defended this action, save defendant Marvalle Rupert. The answering defendants essentially contend that they should be relieved of any legal liability on the loan, mortgages, and guarantees inasmuch as the SBA,

acting through its agents, was a party to a transaction that was illegal and against public policy.

Additionally, this Court, in a Memorandum and Order filed March 23, 1978, allowed defendant Luxury to file what is denominated a third-party complaint. In it, A. Vernon Weaver, then Administrator of the SBA, was named as a third-party defendant. Luxury alleged that it was entitled to a $260,000 judgment because of damages sustained as a result of the SBA's failure to comply with federal regulations and its breach of duties allegedly owed to Luxury.

Following four years of pretrial procedures, the cause finally came on for trial to this Court without the intervention of a jury. The trial lasted two days and closing arguments

were briefed. This Opinion and Order will serve as the Court's findings of fact and conclusions of law. Fed. R. Civ. P. 52(a).

Although since its inception this cause has been bitterly contested, a review of the record reveals that the genuine disputes concern not so much the facts as the parties perceive them, rather they involve the inferences to be drawn therefrom. Furthermore, this cause poses some unique and difficult questions of law concerning a party's ability to escape liability on what in essence is a government obligation.

The evidence shows that at the time this cause was tried, defendant Luxury was an Ohio corporation engaged in the business of blanket manufacturing. The corporation began

its operations in 1946, when it was organized by defendant, Benjamin Rupert, his brother, Irving, and two others. The business had been operating as a going concern up to and including the time of the events giving rise to this lawsuit.

Defendant Luxury's place of operation, from 1946 until 1969, was located on Nagle Street in St. Mary's, Ohio. Sometime in the mid-1960's defendant Benjamin Rupert, president of defendant Luxury, decided that the corporation's operations should be expanded, and to that end a larger property eventually was purchased to house the blanket business. Defendant Luxury's operations eventually were moved from the Nagle Street address to the new property, located on Greenville Road in St. Mary's.

Much of the financing for the blanket business, came from the only bank in St. Mary's, the Home Banking Company (HBC). During the period of time germane to this action, its president was Norman Kuhlman.

To expand the corporation in the latter part of the 1960's, Luxury required the infusion of additional capital. The Home Banking Company, however, had reached, perhaps even exceeded, its lending limit with respect to Luxury. Benjamin Rupert was aware of this fact. An alternate source of funds, consequently, had to be secured.

Mr. Kuhlman approached the SBA to see if it could provide the necessary capital. Defendant Rupert, however, would have preferred the HBC

and the First National Bank of Celina, Ohio, to co-sponsor the financing.

In any event, late in 1968 or early in 1969 Mr. Kuhlman obtained from the SBA, through Albert Mazza, the SBA representative in charge of the area's 502 Loan Division, its commitment to participate in a small business loan to Luxury. As a consequence the HBC provided interim financing for the project. Apparently the bank's loan limit did not apply to loans made after the SBA had given the HBC its assurance that the expansion project financing would be guaranteed by the agency. In fact, the SBA guaranteed loan, upon disbursal, was to be used in large measure as credit against those loans made in light of the assurance of SBA participation.

Albert Mazza operated out of Columbus, Ohio. He worked for the SBA in Pittsburg, Pennsylvania, prior to his moving to Columbus in the fall of 1968. While in Pittsburg, Mr. Mazza underwent some financial difficulties. The Mellon National Bank of Pittsburg obtained a judgment against him.

Mr. Mazza entered into a contract for the sale of land in Columbus. To consumate the deal, he was obliged to obtain financing by the end of 1969. However, he could not acquire a home loan in the Columbus area. He eventually obtained a loan from the HBC in St. Mary's in December of 1969, arranged by Mr. Kuhlman. Shortly thereafter this loan was sold to the Celina National Life Insurance Company. Mr. Kuhlman was a director of this firm.

The evidence further shows that in June, 1969, the SBA approved the loan applications submitted by the HBC and the Community Improvement Corporation (CIC), and authorized an SBA guaranteed loan in the amount of $220,000 to be paid by the HBC to the CIC for the benefit of defendant Luxury. The SBA guaranteed repayment of the loan.

The loan authorization required, inter alia, the CIC to inject $40,000 of the total expansion project cost of $260,000 prior to the provision of any interim financing. Furthermore, this injection was to be in the form of an equity capital donation to defendant Luxury. Also required by the authorization was an attempt by defendant Luxury to sell the Nagle Street property with the resultant proceeds to be

used as working capital. Prior to its sale, rentals received from the property were to be used to defray the costs of doing business. The loan was to be disbursed by Mr. Mazza in accordance with the provisions of the authorization.

On November 17, 1969, most of the documents relevant to this action were executed by the various parties. A promissory note in the amount of $220,000 was executed by Norman Kuhlman, on behalf of the CIC, in favor of the HBC. A $260,000 mortgage note was executed by defendants Benjamin and Elaine Rupert on behalf of defendant Luxury, in favor of the CIC. The reverse side of this note, however, contains a paragraph which states that the CIC shall forgive and consider liquidiated $40,000 of the

principal of said note. This paragraph was endorsed only by a Barrett Kemp, as Secretary of the CIC. A real property mortgage deed, securing the so-called $260,000 note, also was given to the CIC by defendant Luxury.

Contemporaneous with the execution of these documents, the CIC assigned to the HBC its interest in the mortgage note and mortgage deed. Further, defendants Benjamin, Elaine, and Marvalle Rupert unconditionally guaranteed payment of the $220,000 note given by the CIC to the HBC. As further security for the obligation, the CIC took security interests in the machinery and equipment of defendant Luxury, evidenced by financing statements which were duly filed.

On December 15, 1969, the SBA guaranteed loan was disbursed. Four

creditors of Luxury were paid a total of $220,000. The HBC, however, received as credit on its accounts with Luxury all of the sum except $42,612.32.

The evidence further shows that the CIC never injected $40,000, in any form, into the Luxury expansion project, as it was required to do by the express language of the loan authorization. Although the evidence is not entirely clear on just who concocted the so-called $40,000 forgiveness by CIC scheme, there is no real doubt but that it was the project of Albert Mazza's imagination. He and Mr. Kuhlman were well aware that unless a paper charade was designed to somehow account for the required capital donation by the CIC, the loan might not receive SBA saction. Consequently, the SBA probably would not have guaranteed the

loan, the HBC would have grossly exceeded its lending limit to Luxury, and Mr. Kuhlman would have been in serious trouble.

There is no dispute about the fact that Luxury did not owe the CIC $40,000. There also is no doubt that the CIC virtually was penniless. It is clear that the parties simply were attempting to juggle figures so as to insure SBA's guarantee of the loan. Hence, the paper sham, of the details of which Mr. Rupert was not aware when signing the stack of documents on November 17, 1969.

The evidence further shows that, according to the SBA's loan authorization, the loan should not have been disbursed absent evidence of the CIC's required injection. It nevertheless was. It is no mere coincidence

that the loan closing date closely parallels Mr. Mazza's home loan from the HBC. The two transactions are part and parcel of the same scheme to secure the SBA's guarantee on a loan that otherwise might not have been guaranteed, and represent quid pro quo's between Mazza and Kuhlman.

The SBA did not waive the required injection by the CIC either before the loan was approved, when the loan was authorized, or when the proceeds were disbursed.

As already noted, the loan authorization required defendant Luxury to assign its rights to the rent from the Nagle Street property to the CIC. The authorization further notes that the rentals could be deposited into an account for defendant Luxury, to be

used as working capital. Defendant Luxury also contracted with the CIC, again in accordance with the authorization, to sell the same Nagle Street property. The proceeds of the sale were to liquidate any liens on the property and to provide defendant Luxury with working capital.

Once again, Mr. Kuhlman enters the picture. Two firms in which he was a principal successively occupied the Nagle Street property. Unfortunately, they failed and at least one of them was unable to pay the rents. It also is fair to infer that Mr. Kuhlman, as president of the only bank in town, was not eager to have the property sold inasmuch as it provided him with a place to store his firm's equipment for little or no rent.

Defendant Luxury, however, did not introduce any credible evidence tending to show that Kuhlman or the HBC actually impeded any prospective sale. Neither did Luxury produce a willing buyer who was discouraged by the HBC in an attempt to buy the property. The Nagle Street property eventually was sold at a price sufficient only to pay off the mortgage on it held by the HBC.

The evidence further shows that in June of 1970, William Arnold, the SBA employee in the Cleveland District who was given responsibility for the Luxury Blanket loan, noticed that the CIC did not inject the $40,000 as it was required to do by the loan authorization. He questioned Mr. Mazza about this but failed to receive an answer that made any sense. He then

took it upon himself to visit St. Mary's to investigate the matter.

On this first visit Mr. Arnold separately met with both Mr. Rupert and Mr. Kuhlman. When he visited defendant Luxury the plant effectively had been shut down. He questioned Mr. Rupert about the exact amount of money he received from the loan transaction but never got a straight answer. He later met with Mr. Kuhlman who also was evasive when interrogated about the exact amount of the loan.

On July 30, 1970, Mr. Arnold accompanied by William McCarthy, the Chief of the district's Loan Administration, again went to St. Mary's. Mr. Rupert informed the SBA representatives that his company actually received only $220,000 from the loan in

question. He told them that the mortgage note was written in the amount of $260,000 on the advice of Mr. Kuhlman and Mr. Mazza. Initially he was reluctant to give them access to documents they wanted. Kuhlman became concerned about the SBA not honoring the Guarantee Agreement when he was informed that the forgiveness scheme violated the loan authorization. The July 30 expedition to St. Mary's was memorialized in a memorandum penned by Mr. McCarthy and mailed to the Chicago SBA regional office. In it, sundry irregularities in the Luxury loan are catalogued, including the lack of the CIC injection.

Thereafter the SBA's Security and Investigations Division became involved in solving what seems to have been the mystery of the phantom $40,000

injection. In late August of 1970, Mr. McCarthy and a representative of the SBA's investigative division again called on the parties. Mr. Kuhlman then frankly admitted that the CIC never injected the capital as required by the loan authorization. Mr. Kuhlman also told the SBA officials about the Mazza home loan and the fact that the HBC had exceeded its lending limit to defendant Luxury. The memorandum recounting this trip to St. Mary's contained, inter alia, Mr. McCarthy's belief that the loan was a "bail out" for the HBC's overexposure with respect to defendant Luxury.

Review of the file by who appears to have been the SBA's district counsel resulted in his conclusion that the CIC generally complied with the terms of the loan except for the "paper

transaction subterfuge" regarding the mortgage note.

In late August or early September, 1970, Mr. Kuhlman went to Washington, D.C. and met with a Mr. Boland, an SBA representative. At that meeting Mr. Kuhlman discussed the entire situation, explaining to the SBA official that at the time of the loan's making, he, Mr. Mazza, and Mr. Benjamin Rupert all were aware that the CIC could not inject any capital into the project.

Finally, on January 15, 1971, Glenn Swanson, Acting Director of the SBA's Office of Community Development, concluded that the injection which the CIC should have made in fact was made by defendant Luxury, in contravention of SBA policy. He further concluded that there was no reason to believe

that there was a conspiracy between the CIC and Mr. Mazza. Finally, he stated that the CIC contributed enough of the project's funds to comply with 13 C.F.R. 108.502-1(e).

The loan became delinquent shortly after it was made, and the SBA eventually purchased the loan, honoring its guarantee contract with the HBC. The SBA also was assigned the various notes, guarantee agreements, and collateral documents. Further, the HBC and Luxury Blankets, or Benjamin Rupert, became involved in state court litigation. The result of this litigation was a mutual release of claims executed by, among others, the HBC, defendant Luxury Blankets, Benjamin Rupert doing business as Blanket Rentals, and the CIC. The mutual release was endorsed by the parties in

July, 1973. The various notes, collateral documents and guarantees, however, were assigned to the SBA prior to the execution of the mutual release.

The parties agree that the SBA is the holder of the promissory note, collateral documents, and personal guarantees. Additionally, they agree that as of December 20, 1979, the total indebtedness on the loan was $335,245.11, with interest accruing daily. When defendants' contentions are stripped of their emotional gloss, the principal issues to be resolved are whether or not: (1) the entire transaction was so tainted by illegality as to render the obligations unenforceable; (2) public policy militates against enforcement of the obligations; and (3) the plaintiff is estopped from recovering in this

action.[1]

The threshold issue, however, is one raised by the Government. It categorically asserts that pursuant to Section 10 of the Administrative Procedure Act (APA) this Court permissibly may not review conditions for the granting of SBA loans since this agency action is "committed to agency discretion by law." 5 U.S.C. Sec. 701(a)(2). Plaintiff overstates its case.

The Court acknowledges that various courts have held that SBA decisions concerning the granting or renewal of government loans represent unreviewable agency actions. See, e.g., United States v. Capital Assistance

[1] The defendants, in their answer to the amended complaint, asserted that the loan was not supported by consideration. They apparently have abandoned this defense, inasmuch they do not so contend in their written argument. In any event, it is clear that the contract was substantially performed and supported by adequate consideration.

Corp., 460 F.2d 256 (9th Cir.), cert. denied, 409 U.S. 941 (1972). These decisions, however, are not dispositive of one of the central issues herein, i.e., whether or not the lack of capital injection by the CIC, engineered by an SBA official, renders the obligation illegal or unenforceable on grounds of public policy.

Plaintiff directs the Court's attention to the narrow exception to the general rule favoring reviewability of agency actions, yet fails to recognize the existence of 5 U.S.C. Sec. 706. That provision of the APA entitled "Scope of Review" provides in part:

> To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning of applicability of terms of an agency action. The reviewing court shall -

(1)...

(2) hold unlawful and set aside agency action, findings and conclusions found to be -

(a) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;
(b)...
(c) in excess of statutory ... authority, or limitations, or short of statutory right.

5 U.S.C. Sec. 706 (emphasis added).

Courts interpreting the contradictory mandates contained in 5 U.S.C. Sections 701 and 706 have resolved the rather anamolous situation in such a way as to allow a modicum of judicial review of actions admittedly "committed to agency discretion by law." As the Third Circuit recently stated:

> Even when a court ascertains that a matter has been comitted to agency discretion by law, it may entertain charges that the agency lacked

> jurisdiction, that the agency's decision was occasioned by impermissible influences, such as fraud or bribery, or that the decision violates constitutional, statutory, or regulatory commands.

Local 2855, AFGE (AFL-CIO) v. United States, 602 F.2d 574 (3rd Cir. 1979); accord, Ness Investment Corp. v. United States Dept. of Agricultural Forests 512 F.2d 706 (9th Cir. 1975); cf. Inner City Broadcasting Corp. v. Cardenas 554 F.Supp. 42 (D.D.C 1982). It should be noted, however, that an agency's interpretation of its own regulation will be upheld unless that interpretation is "plainly erroneous or inconsistent." Morrison & Morrison, Inc. v. Secretary of Labor, 626 F.2d 771, 773 (10th Cir. 1980) (quoting United States v. Larionoff, 431 U.S. 864, 872 (1977).

The loan in question was made pursuant to Section 502 of the Small

Business Investment Act, 15 U.S.C. Sec. 696. The statute in force during the time germane to this action provided in part:

> The Administration may... make loans for plant construction, conversion, or expansion, including the acquisition of land, to state and local development companies, and such loans may be made or effected either directly or in cooperation with banks or other lending institutions through agreements to participate on an immediate or deferred basis: Provided, however, ...
>
> (1) All loans made shall be so secured as reasonably to assure repayment. In agreements to participate in loans on a deferred basis under this subsection, such participation by the Administration shall not be in excess of 90 per centum of the balance of the loan outstanding at the time of disbursement.
>
> (2) The proceeds of any such loan shall be used solely by such borrower to assist an identifiable small-business concern and for a sound business purpose approved by the Administration.

(3)...

(4) Any development company assisted under this section must meet criteria established by the Administration, including the extent of participation to be required or amount of paid-in-capital to to be used in each instance as is determined to be reasonable by the Administration.

Id. (emphasis added), amended by 15 U.S.C. Sec. 696.

The regulations promulgated by the SBA to implement Section 502 are found at 13 C.F.R. Sec. 108.502-1. The Relevant regulation in force when this loan was made provided in part as follows:

> Participation by the development company. A development company may be required to furnish a reasonable part, as determined by SBA, of the funds necessary to accomplish the plant construction, conversion, or expansion, or the acquisition of land. For the purposes of this paragraph, the furnishing of not less than 20 percent of the neces-

> sary funds shall generally be considered a reasonable part.

13 C.F.R. Sec. 108-502-1(e)(1969) (emphasis added). This regulation then catalogued four exceptions to the normal twenty percent injection requirement by the development company. However, none of these exceptions have been advanced by plaintiff to justify waiving a capital injection by the CIC. Further, the exceptions do not sanction waiving the capital injection altogether. In fact, the regulation only allowed reduction of the twenty percent requirement by one half.[2]

[2] The Government has argued that the CIC was a "hardship case," thereby justifying the CIC's failure to supply Luxury with the $40,000 capital injection. To support this position the Government refers the Court to a version of 13 C.F.R. 108.502-1(e) which postdated the making of this loan, and stated that exceptions to the general rule requiring development companies to furnish funds for the small business concern

Also relevant to this cause is Sec. 120.2(d)(1)(i) (1969) which stated that:

> Financial assistance will not be granted by SBA...(i)f the direct or indirect purpose or result of granting such assistance would be to...(p)ay off a creditor or creditor of an applicant who are inadequately secured and are in a position to sustain a loss.

Upon review of the record in

---

could be made in certain hardship cases. While the CIC may well have been such a case, the fact remains that at the time this loan was negotiated and disbursed the SBA regulations made no reference to such an exception. Perhaps that is why there is no suggestion in the record of any SBA determination to the effect that the CIC was a hardship case. Perhaps that is also why the Loan Authorization clearly contemplated the CIC's injection of $40,000. In any event, the legality of the Luxury loan must be measured against the statutory and regulatory commands in force when the loan was made, not subsequent amendments thereto. Anyhow, Sec. 108.502-1(e) as it read in 1969 did not mandate that a development company must always furnish a reasonable amount of funds to accomplish the loan's purpose.

this cause and the applicable law, the Court is convinced that defendants have failed to shoulder their burden of establishing the affirmative defense of illegality, nor has the Court discerned any such illegality. To be sure, normally a local development company would have to contribute some sum toward the total project costs. The language of both the statutory predicate for the loan in question and the pertinent federal regulation, Sec. 108.502-1(e), however, clearly is couched in permissive, rather than mandatory language. Obviously, the SBA has considerable discretion in administering the Section 502 loan program and permissibly may not require any capital injection by a development company in the first instance. Defendants have failed to show the Court any authority holding that

the failure by the CIC to inject funds or comply with the loan authorization renders the obligations sued on void and therefore unenforceable.

Nor have defendants established that the loan was an illegal "bail out" for the HBC. Assuming, without deciding, that the proscription against bailing out an overexposed creditor validly can be asserted by a small business concern as a defense, defendants have not shown that the HBC was inadequately secured or in a position to sustain any loss at all. In fact, the record shows that much of HBC's exposure was a direct result of the assurrance of SBA participation in the loans.

Were the Court to find the subject loan transaction illegal, the result would be the same. As the Ninth

Circuit Court of Appeals stated in a suit by a bank against the SBA to recover on the guarantee agreement executed by the agency:

> It has long been true that although a court will not ordinarily allow recovery on an illegal contract (citation omitted), the illegality of a contract does not automatically render it unenforceable. (citations omitted). Out of the welter of common law rules regarding illegality has come the general principal that illegal contracts are unenforceable only where (1) a statute explicitly provides that contracts contravening it are void or (2) where "the interest in (the contract's) enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms." Restatement (Second) of Contracts Sec. 320(1) at 53 (Tent. Draft No. 12, March 1, 1977). (Adopted and now found in Restatement (Second) of Contracts Sec. 178 (1981))

California Pacific Bank v. SBA, 557 F. 2d 218 (9th Cir. 1977).

Defendants have not offered, and this Court has not discovered, any statutory or regulatory directive indicating that failure of the local development company to inject the capital normally required renders the underlying obligation void. Further, Restatement (Second) Contracts Sec. 178 Comment b (1981), states that "(e)nforcement will be denied only if the factors that argue against enforcement clearly outweigh the law's traditional interest in protecting the expectations of the parties, its abhorrence of any unjust enrichment, and any public interest in the enforcement of the particular term." The evidence clearly shows that defendants intended to, and did receive $220,000 of financial assistance. It

also is clear that they intended to be responsible for it. Moreover, to allow defendants to escape liability certainly would result in their unjust enrichment at the expense of the public fisc. Finally, the public interest certainly weighs in favor of enforcing the obligations, not only because of the public funds at stake, but because the loan in fact was used for its intended purposes. In short, assuming the loan's technical illegality, the Court still would find that public policy weighs heavily in favor of enforcement of the obligations.

Next, defendants Rupert and Luxury would have this Court hold that the SBA is estopped from recovering on the various obligations and foreclosure. They contend that Albert Mazza, the SBA representative who handled the

loan initially, engaged in affirmative misconduct which later was ratified by his superiors, thereby justifying their estoppel defense. The Court, however, finds that defendants have failed in their proof on this affirmative defense.

A party claiming estoppel against the United States or a federal agency performing governmental services bears a heavy burden. Sigmon Fuel Co. v. Tennessee Valley Authority, 531 F. Supp. 80 (E.D. Tenn. 1982), rev'd on other grounds, 709 F.2d 440 (6th Cir. 1983). See generally K. Davis, Administrative Law of the Seventies Sections 17.01-17.04 (1976). In Federal Crop Insurance Corp. v. Merrill, 332 U.S. 380 (1947), the Supreme Court held that in general a private party dealing with the Government assumes the risk that the Government's agent may be wrong.

However, this dogmatic approach has been ameliorated to some extent, and "(t)he doctrine of equitable estoppel as applied to the government has undergone considerable development since (Merrill)." Rogers v. Tennessee Valley Authority, 692 F.2d 35 (6th Cir. 1982).

Lower courts have been uncomfortable with the rather harsh rule enunciated in Merrill and as a result have added varying amounts of judicial gloss to the anachronistic notion that the king can do no wrong. Unfortunately, the current state of the law is in woeful disarray. As the Sixth Circuit recently noted, some Courts of Appeals have held that the Government may be estopped if the traditional elements of estoppel are present and the party can show that a governmental agent engaged in "affirma-

tive misconduct." See id. at 37. Other courts have analyzed the estoppel of Government question by determining whether or not the Government was acting in a proprietary rather than sovereign capacity. Id. The Supreme Court itself recently added to the confusion.

In Schweiker v. Hansen, 450 U.S. 785 (1981) (per curiam), the Supreme Court summarily reversed a decision by the Second Circuit which held that the Social Security Administration (SSA) was estopped from denying retroactive benefits to a claimant. In Hansen, the claimant was told by a SSA field representative that she was not eligible for benefits. The field representative was wrong about the claimant's eligibility, and failed to comply with the SSA's Claims Manual as well by not advising the claimant to

file a written application. Nevertheless, the Supreme Court upheld the SSA's refusal to award retroactive benefits because the plaintiff did not comply with the regulations that required a written application as a prerequisite to receipt of benefits. The Court held that the conduct of the field representative fell short "of conduct which would raise a serious question whether petitioner is estopped from insisting upon compliance with the valid regualtion." Id. at 790.

Unfortunately, the Court did not use the case as a vehicle to clearly elucidate the circumstances wherein the federal government might be estopped. The decision, however, arguably can be read as requiring a showing of "affirmative misconduct" on the part of the Government before estoppel would

operate against it.[3]

Although two district courts within this circuit have required a showing of "affirmative misconduct" on the part of the Government in addition to the other elements necessary for equitable estoppel, see State of Tennessee v. Dole, 567 F.Supp. 704, 719-20 (M.D. Tenn. 1983); Sigmon Fuel Co., 531 F.Supp. at 82, the Sixth Circuit recently noted that in this circuit the issue remains unresolved. In finding that the plaintiff failed to show any reliance on an act by the T.V.A., the Court of Appeals found that an element of "an ordinary claim of estoppel" was wanting. Rogers, 692 F.2d at 38. The Court then expressly stated that because of this it did not have to "de-

[3] For a concise critique of the Hansen decision, see 4 K. Davis, Administrative Law Treatise Sec. 20:5 (2d ed. 1983).

cide the question of whether 'affirmative misconduct' is a necessary element to a claim of estoppel against the government in this Circuit." Id. at 38-39.

This Court finds itself in a similar situation. The traditional elements of equitable estoppel have been succinctly summarized by the Ninth Circuit as:

> (1) The party to be estopped must know the facts;
>
> (2) He must intend that his conduct shall be acted on or must so act that the party asserting the estoppel has a right to believe it is so intended;
>
> (3) The latter must be ignorant of the true facts; and
>
> (4) He must rely on the former's conduct to his injury.

United States v. Ruby, Co., 588 F.2d 697, 703 (9th Cir. 1978), cert. denied,

442 U.S. 917 (1979) (citations omitted). See also Pratte v. N.L.R.B., 683 F.2d 1038, 1041 (7th Cir. 1982). A review of the record in this cause reveals that at least two of the traditional elements of estoppel are absent.

The evidence clearly shows that defendant Benjamin Rupert was well aware of the CIC's inability to inject funds into his expansion project. He also was aware that the actual amount of money he would receive was $220,000, not $260,000. Although he may not have been aware of the exact details of the "paper transaction subterfuge" ultimately employed by Mr. Kuhlman and Mr. Mazza to make it look as if the transaction complied with the loan authorization and SBA custom, it cannot be claimed that he was ignorant of the true facts in the matter.

Similarly absent from the evidence is any showing of actual reliance on any representation by Mr. Mazza or that part of the loan authorization indicating that the CIC would inject $40,000. As noted above, Mr. Rupert understood that the loan to him actually would be for $220,000. He was loaned this amount and was financially benefitted in this amount, despite his protestations to the contrary. The estoppel defense, quite simply, does not survive even a semblance of scrutiny.

Defendants have failed to establish a valid defense to the Government's claims against them. The parties have stipulated that the Certified Statement of Account received into evidence is accurate; that the loan is delinquent; and that demands for pay-

ment have been given to the guarantors. Accordingly, the Government is entitled to the relief it seeks in its amended complaint.

Defendants Rupert and Luxury filed what is denominated a third-party complaint against the Administrator of the SBA. In the "complaint" defendants contend that because the SBA knew that $40,000 would not be injected by the CIC, the agency breached its duty to supervise the loan and to assure that the loan was for the benefit of Luxury. The alleged breach, it is urged, has damaged defendants in the not so coincidental amount of $260,000. The Government seriously has maintained only that defendants' claim is barred because of the mutual release executed in July of 1973; the claim of defendants sounds in tort, and therefore is

barred for failure to comply with the Federal Tort Claims Act, 28 U.S.C. Sec. 2871 et. seq.; the loan authorization, an agreement between the SBA and the HBC, created no enforceable rights in defendants.[4]

The Court concludes that the mutual release does not insulate the SBA from any potential liability arising out of the loan transaction. The document exhibits no intention on the part of defendants to release the SBA from its breach of an alleged duty owed to defendants. To be sure, the document unambiguously states that the defendants released and discharged the HBC and CIC from any liability arising out of the SBA guaranteed loan to

[4] At the close of all evidence, the Government moved to dismiss defendants-third-parties plaintiff complaint, and thereafter briefed the matter. Although the question is a close one, the Court has decided to resolve the issues by weighing all the evidence.

Luxury. Further, the mutual release states that it shall inure to the benefit of the assigns of the parties to the agreement. The SBA is an assignee of the HBC. The Court acknowledges that release of one joint tortfeasor without an express reservation of rights operates as a release of all joint tortfeasors. See Hageman v. Signal L.P. Gas, Inc., 486 F.2d 479 (1973) (applying Ohio law). The release certainly does not reserve any of defendants' rights against any party. Nevertheless, the simple fact of the matter is that the claim against the SBA asserted in this action is separate and distinct from any claims that could have been asserted against the HBC or

the CIC.[5]

There is merit, however, to the Government's contention that defendants' claim sounds in tort. The Court of Claims has had occasion to state that "claims based on negligent misrepresentation, wrongful inducement, or the careless performance of a duty allegedly owed are claims sounding in tort." Somali Development Bank v. United States, 508 F.2d 817 (Ct. Cl. 1974). Characterized as a tort, it would seem that the Federal Tort Claims Act, 28 U.S.C. Sec. 2671 et. seq., applies to defendants' claim. Although 28 U.S.C. Sec. 2675 generally requires a claimant to present his

5 Another consideration is the fact that the SBA was assigned the note, guarantees and collateral documents months before the execution of the mutual release. It stretches credulity to argue that the "assigns clause" in the mutual release was intended to apply retroactively so as to absolve theSBA from any potential liability.

claim to the appropriate federal agency before invoking a court's jurisdiction, which defendants have not done that statute excepts from its operation third-party complaints and counterclaims.

Nevertheless, characterizing the SBA's action, or inaction, as tortious would result in the conclusion that the claim asserted by defendants probably is not even actionable. Title 28 U.S.C. Sec. 2860(a) exempts the Government from liability for actions undertaken in its performance of discretionary functions while Sec. 2860(h) shields the Government from liability for most intentional torts.

Defendants' claim does, however, admit of a contract interpretation. They apparently rely on 15 U.S.C. Sec. 631 which states in part

that "it is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as possible, the interest of small-business concerns....," and the terms of the loan authorization reciting that the CIC would make a capital donation.

Unfortunately, defendants fail to refer the Court to any authority whatsoever to support the proposition that the general policy statement found in Sec. 631 somehow imposes upon the SBA a "duty" owing to defendant Luxury. This Court will not now create one.

With respect to defendants' implicit contention that defendant Luxury is a third-party beneficiary of the loan authorization, the short answer is that an intended beneficiary possesses

no contract rights unless and until a valid contract is formed between the promisor and promisee. See Restatement (Second) Contracts Sec. 309 (1981). The Loan Authorization is endorsed only by Albert Mazza and does not explicitly bind the HBC and CIC to anything. The Authorization merely states conditions that must be met before the loan's disbursal. In any event, the SBA certainly did not promise to provide Luxury with the $40,000. Defendants' recourse under a third-party beneficiary theory therefore would be against the CIC as promisor. See id. Sec. 304. Further, the language of the authorization reveals that it is intertwined with the then impending execution by the HBC and the SBA of a Guarantee Agreement. To a certain extent, then, defendants are claiming enforceable contract rights on

the basis of the guarantee contract. This agreement, however, created no enforceable rights in defendants. See United States v. Perkins, 71 F.R.D. 22 (E.D. Okla. 1975); United States v. Martin, 344 F.Supp. 350 (E.D. Mich. 1972). Additionally, as has been noted earlier, defendants knew full well that a $40,000 injection would not be made by the CIC. If they really believed what the authorization seems to say, the "breach" in fact occurred when interim financing first began inasmuch as the injection had not been made at that time. Defendants, however, did not protest until after the commencement of this action.

In short, defendants have failed to show (1) a specific duty owed to Luxury that was breached by the SBA; (2) any reliance on the loan authoriza-

tion provision concerning the $40,000 injection of capital; and (3) any enforceable third-party beneficiary rights against the SBA.

Plaintiff, after the trial of this cause, moved for an order granting it default judgments against defendants Elaine and Marvalle Rupert. The latter defendant has failed to plead or otherwise defend in this action and accordingly plaintiff's motion as to this defendant shall be sustained. With respect to defendant Elaine Rupert, to the extent that the motion as to her is not now moot, plaintiff's motion is overruled. Elaine Rupert pled and defended in this, although she was not present during trial when called as a witness by plaintiff. Yet she was represented by counsel throughout the trial and plaintiff's counsel, upon

learning of her illness, stated that he would forego examination of her. Plaintiff's counsel's own words suggest that it was neither prejudiced by her absence, nor entitled to the order sought.

Also named as defendants in plaintiff's amended complaint, because of their possible interest in the property subject to foreclosure, are Tecumseh Corrugated Box Co., State of Ohio Bureau of Employment Compensation, State of Ohio Department of Taxation, and the Treasurer of Auglaize County. Tecumseh and the Bureau of Employment Compensation claim no interest in the property and therefore are entitled to no relief from this Court. The Ohio Department of Taxation, however, filed with its amended answer a cross-claim against defendant Luxury in which it

asserts that Luxury is indebted to it in the amount of $865.93, plus interest, by reason of certificates of judgment duly filed in Auglaize County. Defendant Luxury answered the cross-claim, stating that it was without information sufficient to form a belief as to the truth of the State's averments concerning the tax liens. However, the certificates of judgments were filed and recorded in 1976 and 1977, while defendant answered the cross-claim in April, 1979.

At the time the cross-claim was answered by defendant Luxury, Rule 11 of the Federal Rules of Civil Procedure provided in part that:

> The signature of an attorney constitutes a certificate by him that he has read the pleading; that to the best of his knowledge, information, and belief there is good ground to support it; and

> that it is not interposed for delay. If a pleading ... is signed with intent to defeat the purpose of this Rule, it may be striken as sham and false and the action may proceed as though the pleading had not been served.

The Court concludes that defendant Luxury's answer to the cross-claim does not constitute a denial of the State's averments contained therein. The slightest bit of diligence would have revealed their truth or falsity so that they could have been admitted or denied. Consequently, the Court disregards the answer to the cross-claim and the State is entitled to its rightful share of the proceeds in the event of a sale of the subject property. See also Fed. R. Civ. P. 11 (as amended April 28, 1983).

The Treasurer of Auglaize County, however, is not so fortunate.

The County, in its answer to the amended complaint, states that there is due and owing real and personal property taxes which are the first and best liens against the property in question. The County, however, never filed a cross-claim against defendant Luxury seeking affirmative relief. Therefore, the averments in its answer, for purposes of this litigation, are taken as denied or avoided, Fed. R. Civ. P. 8(d), inasmuch as no response by defendant Luxury was required. Further, the County did not appear at trial to establish the claims made in its answer. Accordingly, the Court cannot now hold that the County is entitled to any proceeds resulting from sale of the property securing the SBA loan. To the extent that the County's answer can be construed as containing a cross-claim,

it is dismissed without prejudice.

THEREFORE, for the above stated reasons, good cause therefore appearing, it is

ORDERED that plaintiff's motion for default judgment against defendant Elaine Rupert should be, and it hereby is, OVERRULED; and it is

FURTHER ORDERED that plaintiff's motion for default judgment against defendant Marvalle Rupert should be, and it hereby is, SUSTAINED; and it is

FURTHER ORDERED that plaintiff's motion to dismiss should be, and it hereby is, OVERRULED; and it is

FURTHER ORDERED that plaintiff is entitled to the relief prayed for in its complaint. Plaintiff shall confer with defendant-cross-claimant State of Ohio Department of Taxation

concerning relative priorities; and it is

FURTHER ORDERED that plaintiff shall, within thirty (30) days, prepare and serve upon any party who has appeared in this action a draft of an order of judgment embodying this Court's decision. Any party receiving the proposed draft shall respond to it in accordance with L. Civ. R. 5.02.

IT IS SO ORDERED.

/s/ Don J. Young
Sr. United States
District Judge

Toledo, Ohio.